Competition and the Future of M&A Litigation

Charles R. Korsmo & Minor Myers***

Matthew Cain and Steven Davidoff Solomon's Article, *A Great Game: The Dynamics of State Competition and Litigation,*[1] is a modern-day classic. It begins with an interesting question, presents fascinating results emerging from a herculean data collection effort, and makes an important contribution to our understanding of contemporary merger litigation. The influence of this Article is difficult to overstate: It has sparked a major policy debate in corporate law, and it serves as the essential starting point for a mountain of academic work (including our own).

In this response, we explain why the Article has proven so important, we examine the implications of its findings, and we address, in brief, the basic policy question raised by the Article: What, if anything, to do about merger litigation? In our view—a view that emerges from the landscape painted by Cain and Solomon—merger class action litigation is a fundamentally broken mechanism that ought to be either radically reformed or eliminated altogether. Forum selection clauses represent a potentially useful reform and such usage would be a step in the right direction. We do not, however, believe that such clauses would alter the basic structural dynamics driving the pathologies of modern merger litigation.

---

* Charles R. Korsmo is an Assistant Professor at Case Western Reserve University School of Law.

** Minor Myers is an Associate Professor at Brooklyn Law School.

1. Matthew D. Cain and Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 IOWA L. REV. 465 (2015). For another response to Cain and Solomon's Article, see Lawrence A. Hamermesh, *How Long Do We Have to Play the "Great Game"?*, 100 IOWA L. REV. BULL. 31 (2015).

I. THE INFLUENCE OF CAIN AND SOLOMON'S PAPER

The basic debate in the literature over the desirability (or existence) of state competition for incorporations has focused chiefly on the production of substantive corporate law. Substantive law, of course, matters only if enforced, and derivative and class action litigation are the mechanisms of enforcement. Litigation and litigants played a prominent role in Jonathan Macey and Geoffrey Miller's interest group theory of Delaware law. They posited that "the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state."[2] The question that Cain and Solomon investigate is the related and fascinating possibility that states might compete not only for incorporations through the production of substantive law but also for litigation.

Answering this question requires comprehensive data on the incidence of litigation in a context where competition is possible. Cain and Solomon examine merger litigation, a natural setting. Prior to Cain and Solomon's heroic efforts, a comprehensive empirical picture of litigation simply did not exist. In their Article, they present an extraordinary hand-collected data set on merger litigation from 2005 through 2011. Their data cover 1,117 transactions, 627 of which—approximately 56%—attracted litigation. The rising incidence of merger litigation was not an entirely unexpected phenomenon, thanks to the important study by Professors Randall Thomas and Robert Thompson that examined litigation in the Delaware Court of Chancery between 1999 and 2000.[3] But the descriptive statistics that Cain and Solomon present in their Article are extraordinary, revealing for the first time the sheer scale of the recent change.

Cain and Solomon document a staggering increase in the incidence of merger litigation over their study period. As late as 2007, only approximately 40% of transactions faced a fiduciary class action. While it is possible to question whether almost half of merger transactions involved conduct that could be plausibly characterized as a breach of fiduciary duty, a 40% incidence of litigation at least suggests some discrimination is being applied in deciding to file a class action. The same cannot be said of merger litigation today. By 2011, over 90% of transactions spawned fiduciary duty class actions. Either corporate boards have suddenly become dramatically more villainous, or Cain and Solomon have uncovered evidence that plaintiffs' attorneys are now filing challenges to merger transactions virtually indiscriminately.

In early 2012, Cain and Solomon publicly released the working paper that became the present Article. The working paper immediately attracted a

2. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 472 (1987).

3. *See* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004).

great deal of attention for documenting this tremendous explosion in merger litigation. Their paper rightfully became famous, or at least whatever the equivalent of "famous" is in the context of academic work—it was never, to our knowledge, trending on Twitter. Twitter aside, however, it has generated enough attention and influence to make any law professor envious, which seems as good a marker of academic fame as any.

As of the date of this writing, their Article—only now being published—has been cited by 22 published law review Articles. For perspective, that is more citations than some tenured law professors will get in their entire academic careers (we did not have the courage to check whether we meet that threshold). The influential commentator Alison Frankel called their draft paper a "must read" study.[4] It has been cited in court opinions,[5] in amicus briefs to the U.S. Supreme Court,[6] and referenced by countless prominent law firms.[7] The U.S Chamber of Commerce Institute for Legal Reform used it as a centerpiece of their argument against what it called the "merger tax" generated by litigation.[8] At academic conferences, Cain and Solomon's paper is the starting point for work on contemporary stockholder litigation. Indeed, our work—separately and together—has attempted to build on their findings.[9] Their working paper has been downloaded approximately 1,100 times from SSRN (again we decline to embarrass ourselves by comparing that download figure to our own). Demand for their findings has been so strong that it has turned into a franchise; Cain and Solomon issue annual follow-up papers that report merger litigation for years following their study period in this Article. Those have been downloaded from SSRN approximately 1,500 as of the time of this writing, and these spinoff papers have themselves been cited

4. Allison Frankel, *Must Read: Deal Prof's Study of Competition for M&A Litigation*, REUTERS (Jan. 17, 2012), http://blogs.reuters.com/alison-frankel/2012/01/17/must-read-deal-profs-study-of-competition-for-ma-litigation.

5. *In re* NYSE Euronext Shareholders/ICE Litig., 965 N.Y.S.2d 278, 282 (N.Y. Sup. Ct. 2013) (citing Cain and Solomon for their "startling statistics" about the incidence of merger litigation).

6. Brief of Former SEC Commissioners and Officials and Law and Finance Professors as Amici Curiae in Support of Petitioners at 10, Amgen Inc. v. Connecticut Ret. Plans and Trust Funds, 133 S. Ct. 1184 (2013) (No. 11-1085), 2012 WL 3027169.

7. *See* Adam O. Emmerich & Trevor S. Norwitz, *An Antidote to Multiforum Shareholder Litigation*, *in* THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: MERGERS & ACQUISITIONS 2014 (8TH ED.) *available at* http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.23133.14.pdf.

8. *See The Trial Lawyers' New Merger Tax: Corporate Mergers and the Mega Million-Dollar Litigation Toll on Our Economy*, U.S. CHAMBER INST. FOR LEGAL REFORM (Oct. 24, 2012), http://www.instituteforlegalreform.com/resource/the-trial-lawyers-new-merger-tax-corporate-mergers-and-the-mega-million-dollar-litigation-toll-on-our-economy.

9. *See* Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. (forthcoming 2015); Minor Myers, *Fixing Multi-Forum Shareholder Litigation*, 2014 U. ILL. L. REV. 467 (2014).

on numerous occasions by academic work and by courts.[10]

In short, this is an important paper, and a model of influential scholarly endeavor. The descriptive statistics showing the rise in merger litigation are—by themselves—a vital contribution to our understanding of one of the chief mechanisms of corporate governance, and these findings have justly attracted attention and influence. This influence grows from the importance and novelty of their findings, and Cain and Solomon deserve enormous credit for doing something too little legal scholarship does: supplying basic descriptive information on the object of study. The only problem is that the tremendous attention paid to their arresting descriptive findings has, at times, threatened to draw focus away from the broader question they actually set out to answer about competition for litigation.

The focus of the conventional incorporation debate is on those in a position to select a state of incorporation—corporate executives and their legal advisors—and the incentives that bear on them. In litigation decisions, however, it is not the corporate manager but rather the plaintiffs' attorney that is cast in the crucial role of the decider. The focus of Cain and Solomon's analysis is thus on the incentives facing plaintiffs' attorneys. They posit that courts possess at least two levers for directly affecting the incentives faced by plaintiffs' attorneys: first, the percentage of cases that survive a motion to dismiss, and second, the amount of attorneys' fees awarded in approved settlements of non-dismissed cases. In addition to their data on the raw incidence of litigation, Cain and Solomon also present new data on these questions. Not surprisingly, in light of prior scholarship, their data reveal that most cases settle and only about 20% are dismissed. Further, plaintiffs' attorneys command handsome fees in settlement even when delivering results of dubious value; the average fee in a disclosure-only settlement is $750,000.

In considering competition for litigation, Cain and Solomon examine two distinct questions. The first is whether plaintiffs respond to differences across courts in dismissal rates and fee awards. That is, do plaintiffs' attorneys actively seek out venues where they have the best chance of surviving a motion to dismiss, and where they will be able to secure the largest legal fee? If the answer to this question is yes, then the second question is whether courts take advantage of this strategic behavior to actively compete to attract filings by being "plaintiff-friendly"—or, really, "plaintiffs' attorney-friendly." On the first question of attorney filing decisions, Cain and Solomon find that plaintiffs' attorneys are more likely to file in the headquarters state if it has an unexpectedly low rate of dismissal.

On the question of court behavior, they find variation across the states.

10. *In re* Ebix, Inc. Stockholder Litig., No. 8526-VCN, 2014 WL 3696655, at *1 (Del. Ch. July 24, 2014) (citing Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2013*, at 2–3 (Ohio State Pub. L. Working Paper No. 236, 2014), *available at* http://ssrn.com/abstract=2377001).

Delaware, for example, awarded higher than expected attorneys' fees and dismissed cases at a higher than expected rate. Illinois, by contrast, dismissed dramatically fewer cases than expected and awarded much lower attorneys' fees than expected. Their empirical tests suggest that states with business courts award higher fees when they have lost out on cases in the past, and Delaware may respond to losing cases by reducing its dismissal rate. In sum, the Cain and Solomon findings suggest there is, indeed, competition for litigation.

II. REFLECTIONS ON COMPETITION FOR STOCKHOLDER LITIGATION

In this section, we focus on some possible limitations of the Cain and Solomon study and draw out some implications of the Article. One threshold issue is what, exactly, is being measured. Each transaction can be challenged by more than one complaint, and the 627 litigated transactions in their sample actually attracted a total of approximately 2,339 individual lawsuits. When multiple suits are filed against the same transaction, they are often filed in more than one court. As Cain and Solomon show, this multi-forum filing pattern has increased alongside the general rise in merger litigation. They acknowledge this, noting that "one driver of multi-jurisdictional litigation may be plaintiffs' attorneys jockeying for fees amongst themselves by filing in differing jurisdictions."[11] The implications of this for the analysis of litigation competition are manifold, and these implications deserve to be the focus of future study.

This observation suggests that the model that Cain and Solomon use to capture what drives the filing decisions of plaintiffs' attorneys is missing an important variable: the likelihood that the plaintiffs' attorney will gain control of the case. Their Article assumes that the dismissal rate and the amount of fee awards drive filing decisions by plaintiffs' attorneys. To be sure, those are likely the two top factors. But a plaintiffs' attorney can only reap substantial benefits from a low dismissal rate and high fee award if he can secure lead plaintiff status in the first place.

Imagine that some fearless jurisdiction decides to dismiss very few cases and also award handsome fees even for disclosure-only settlements. Lots of plaintiffs' attorneys may wish to file in this Shangri-La, but if each individual plaintiffs' attorney has only a small probability of winning lead counsel appointment—the key to securing a fee award—then the expected benefit from filing in the jurisdiction will be attenuated. The attorney may well find himself better off filing elsewhere in a jurisdiction where he is more likely to be granted lead plaintiff status. Each plaintiffs' attorney will try to maximize the expected return from filing, which will be the product of at least three variables: 1) the odds of surviving dismissal and achieving a settlement; 2) the expected fee award; and 3) the odds of being appointed lead counsel. Cain

11. Cain & Solomon, *supra* note 1, at 492 n.115.

and Solomon examine the first two variables but do not incorporate the last.

The requirements for lead plaintiff status—like dismissal rates and fee awards—vary from state to state. Some states privilege fast filers, some may prioritize past successes, and others may be inclined to appoint local attorneys. This variation creates incentives for plaintiffs' attorneys to spread filings across multiple different jurisdictions. Their choices are limited not only to state courts, but include federal courts, too. Cain and Solomon do not make much of the federal court option, treating competition for litigation as something that exists "horizontally based among states and does not have a vertical component to date."[12]

Federal court, however, is a simple option for a fiduciary challenge, requiring only the addition of a federal proxy violation claim or an allegation of diversity among the parties. To a plaintiffs' attorney, filing in federal court is a viable to way to try to win a seat at the bargaining table in litigation. In a study by one of us that looked at filing decisions involving large mergers, more than half of merger targets that were incorporated and headquartered in the same state faced a filing in federal court.[13] For these firms, this approach is the only way to compete for a place at the fee trough. Even among out-of-state-incorporated target firms, more than 25% were sued in federal court.[14] This suggests that competition spans all possible court systems where a plaintiffs' attorney may obtain jurisdiction over the defendants. Furthermore, the additional variable of lead plaintiff rules may also drive competition for litigation for courts and plaintiffs' attorneys. In short, courts may compete for cases by offering rules for appointing lead counsel that differ from those in other jurisdictions. Plaintiffs' attorneys may then seek to avoid crowded jurisdictions and focus their energies on the ones where their chance of winning lead counsel appointment is highest, even if that jurisdiction does not offer the lowest dismissal rate or the highest expected attorney fee.

This possibility has implications for analyzing merger litigation as a policy matter, which we explore below, but also for interpreting Cain and Solomon's results. In their empirical analysis, they treat each deal as facing litigation in one place even if there were filings in multiple jurisdictions. They presumably select the jurisdiction where the case was ultimately settled or dismissed. Their analysis assumes that the plaintiffs' attorney selected that jurisdiction to the exclusion of the others, and did so in response to expectations about dismissal rates and attorney fees.

If there were multi-forum filings—and their results show that happened in half of the 2011 deals—the settlement or dismissal in one jurisdiction may not reveal too much about why the case is there in the first place. The plaintiffs' attorney may have filed in this particular jurisdiction in hopes of

12. *Id.* at 477.

13. Myers, *supra* note 9, at 482–83.

14. *Id.*

winning lead counsel appointment, and the defendants may have decided to settle with the plaintiffs' attorneys in that jurisdiction because they were most pliant. Cain and Solomon have made a major contribution to our understanding of why plaintiffs' attorneys file where they do, and they have laid out a line of research that can plumb more deeply into the motivations and incentives of plaintiffs' attorneys. More work, however, remains to be done to determine the ways in which attorneys make filing decisions and how jurisdictions may compete for litigation activity.

III. THE FUTURE OF MERGER LITIGATION

The findings of Cain and Solomon raise fundamental questions about the future of merger litigation in the U.S. As Cain and Solomon show, almost all deals of any significant size face litigation, most settle, and most settle for nothing more than supplemental disclosures of dubious value and an average attorneys' fee of $750,000. In a recent paper,[15] we add to the bleakness of this picture, showing that the incidence of fiduciary duty class action filings challenging mergers is almost entirely unrelated to the merits. While stockholder actions challenging a proposed merger transaction are generally couched in terms of violations of fiduciary duty, the only issue of genuine consequence to a typical stockholder is the adequacy of the merger consideration. Indeed, in a final period transaction like a merger, a breach of fiduciary duty will generally only be of concern to stockholders if it results in a lower price for their shares. The issues are correlated, of course, but fiduciary violations—at least in this context—can be seen as functioning as a proxy for what really matters: the failure to secure an adequate price.

This failure is at the bottom of any fiduciary claim, and the main reason—if not the *only* reason—a typical stockholder might wish to pursue such a claim. A fiduciary breach that does not lead to a lower price can be, at best, of only theoretical interest to most stockholders. Thus, if the merits mattered in the decision to bring a claim, we would expect to see an inverse relationship between the size of the merger premium and the likelihood of a class action challenging the transaction. If, however, the decision to bring a class action is driven primarily by plaintiffs' attorneys seeking deep pockets from whom to extract a quick settlement, we would expect a stronger relationship between deal size and the likelihood of a class action. And, indeed, this is what we observe—class actions challenging mergers are strongly correlated with deal size, and measures of the adequacy of the merger premium are comparably unimportant.

It is nonetheless possible that this ubiquitous merger litigation actually provides a useful function. Having a properly incentivized plaintiffs' attorney scrutinize each transaction to ensure that those involved have complied with

15. Charles R. Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When Do the Merits Matter?* 75 OHIO ST. L.J. 829 (2014).

their fiduciary obligations could conceivably be the optimal way to police for abusive mergers. The brief for the plaintiffs' attorneys would go something like this: Every merger gets an initial hard look, and the ones that pass scrutiny get off for nothing and a comparatively trivial fee in relation to the size of the deal. These quick settlements of non-problematic cases then allow plaintiffs' attorneys to focus scarce private enforcement resources on the deals that require greater scrutiny.

This story is conceivable but not particularly plausible. Lacking any interest in the ongoing enterprise being sued, plaintiffs' attorneys have little incentive to avoid bringing value-destroying nuisance claims. Perhaps even more problematically, as a risk-averse economic actor, plaintiffs' attorneys have little incentive to aggressively prosecute even meritorious actions. They may be tempted to accept any settlement offer that allows them to recover their out-of-pocket and opportunity costs. In sum, there is little reason to think that plaintiffs' attorneys have the proper incentives to avoid filing non-meritorious claims and to aggressively pursue meritorious claims.

Multi-forum litigation almost certainly plays a role in exacerbating this situation. The phenomenon presents the characteristics of a plausible "race-to-the-bottom" scenario. Jurisdictions can compete to attract filings by offering rules that are attractive to the stakeholder making the filing decision—the plaintiffs' attorneys—and defendants can settle claims by selling to the lowest bidder. The stockholders, as usual, do not have a seat at the table. Cain and Solomon are thus right to identify multi-forum adjudication as a problem, and to the extent their proposed reforms reduce abuses, they may help to blunt these negative dynamics. We suspect, however, that the proposed reforms would only be nibbling at the edges of the problem. Scholars have been documenting the unimportance of the merits in stockholder litigation for decades, long before multi-forum litigation became prevalent.[16] Even in a world with no inter-jurisdictional competition at all, we suspect that most forms of stockholder litigation would remain firmly untethered (to coin an oxymoron) from the merits.

This problem, ultimately, is rooted in the basic structure of stockholder litigation and the unavoidable reality of agency costs in class and derivative actions. The stockholders must rely on the diligence and good faith of the attorney working on their behalf, yet the interests of that attorney can diverge sharply from the interests of the stockholders—most obviously in that the attorney's incentive will be to maximize his fees, rather than the value of the recovery to the stockholders. This agency problem is made especially acute by the fact that it is the plaintiffs' attorney who almost always exercises genuine control over the litigation, for the simple reason that they almost always have

16. *See, e.g.*, Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 STAN. L. REV. 497 (1991); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991).

a financial stake far exceeding that of any individual stockholder. Furthermore, the dispersed stockholders have little practical ability or incentive to effectively monitor the attorneys. As a result, it is the attorneys, and not the stockholders, who decide when to initiate a lawsuit, how to prosecute it, when to settle it, and on what terms.

The use of contingency fees should theoretically help to align the interests of stockholders and their attorneys. The ability to secure sizable attorneys' fees even without any monetary recovery to the stockholders, however, renders this alignment largely illusory. The defendants care only about the aggregate cost of a settlement, and they are typically indifferent as to its allocation among the plaintiffs' attorneys and the stockholders. As a result, plaintiffs' attorneys find a willing partner in abusing their control of the litigation and maximize the value of a settlement going to themselves rather than the putative plaintiffs. And, indeed, Cain and Solomon document the pervasiveness of collusive and low-value settlements in stockholder litigation, showing that approximately 80% of merger class actions end with so-called "disclosure-only" settlements, where stockholders receive no cash at all.

That these phenomena are rooted in the structure of stockholder litigation is further revealed by the counter-example of appraisal litigation, the rise of which we have documented in a forthcoming paper.[17] An appraisal action allows a minority shareholder to dissent from a merger and receive the judicially-determined "fair value" of their shares. As such, an appraisal action seeks to rectify the same harm that ought to underlie other merger litigation—inadequate merger consideration. Yet the structure of an appraisal claim—the composition of the plaintiff class, the cost of bringing a claim, the role of the attorney, the fee shifting rules—is entirely different from the structure of fiduciary class actions. For example, in an appraisal action, there is no class mechanism. Each stockholder must affirmatively opt in and forego the merger consideration. There must necessarily be a real plaintiff with a real economic stake, and it is this plaintiff who hires the lawyer, rather than the other way around. The collective action and agency problems that plague fiduciary duty class actions should thus be largely absent from appraisal.

The nature of the appraisal remedy also works to eliminate the possibility of collusive settlements and reduce the appeal of nuisance litigation. The plaintiff must put real skin into the game by foregoing the merger consideration, and can receive but one form of remedy: cash for the fair value of his shares. The very real possibility that the court may find fair value to be *less* than the merger consideration serves as a deterrent to nuisance litigation. Furthermore, the unavailability of non-cash remedies renders impossible the kind of collusive "disclosure only" settlements seen in other merger litigation. Claims settle for cash or not at all, and the only source of a fee for the

17. *See* Korsmo & Myers, *supra* note 9.

plaintiffs' attorney is the plaintiff himself, either as an hourly fee or as a share of the ultimate cash recovery.

If the pathologies associated with most merger litigation are driven by an agency problem—and by the ability of plaintiffs' attorneys to secure substantial fees even in the absence of any real recovery for the stockholders—we would expect those pathologies to be largely absent in appraisal litigation. And, indeed, we find that the incidence of appraisal litigation is strongly correlated with the merits. Appraisal petitioners appear to be highly selective in initiating litigation, targeting deals with abnormally small merger premia, and aggressively litigating cases all the way to trial at a far higher rate than in other forms of merger litigation.

We believe the most effective way—perhaps the *only* effective way—to alter the dynamics of merger class actions is to alter the structure of such class actions in ways that make them more like appraisal. One possibility would be to simply eliminate the ability of plaintiffs' attorneys to receive fees except as a share of a monetary recovery for stockholders. More radically, as we propose in a new working paper,[18] the stockholder class action could be eliminated altogether and replaced by a market for legal claims—what we call "aggregation by acquisition." This would require both eliminating the opt-in class action and the contemporaneous ownership requirement, which currently poses an obstacle to pursuing a legal claim that arose prior to the plaintiff buying the stock. Eliminating the contemporaneous ownership requirement would allow specialized investors to evaluate the merits of any potential legal claim—such as a merger challenge—before investing, and then affirmatively choose to buy into a meritorious fiduciary claim by buying a large enough stake to justify pursuing a claim. Such a dynamic has already arisen in the appraisal context, and represents a positive development. This phenomenon—often described as "appraisal arbitrage"—will, in our view, lead to superior deterrence of managerial wrongdoing and superior compensation for minority stockholders. Eliminating the traditional opt-out class action would allow this dynamic to emerge in other types of stockholder litigation.

The downside of this reform, of course, is that it would effectively strip many small stockholders of their ability to pursue fiduciary and other claims. This downside, however, is more symbolic than real. As things currently stand, there is little evidence to suggest that minority stockholders—indeed, any stockholders—obtain substantial benefits from the operation of stockholder class actions. Thus, eliminating stockholder class actions would not strip minority shareholders of anything they do not already lack. On the contrary, any loss would be more than offset by the benefits associated with an

18. *See* Charles R. Korsmo & Minor Myers, *Aggregation by Acquisition: Replacing Class Actions with a Market for Legal Claims* (Oct. 1, 2014) (unpublished manuscript) (on file with the Iowa Law Review).

enforcement regime with genuine deterrent power and with the development of a market for arbitrageurs willing to pay a premium when aggregating shares for litigation.

The reform proposals put forward by Cain and Solomon would be a step in the right direction, but given the dire diagnosis of merger litigation that they present, in the end, the reforms can be little more than an inadequate bandage. This patient is in need of more radical surgery.